

A SIMPLER SYSTEM FOR TAXING THE SELF-EMPLOYED

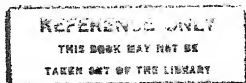
**PROPOSALS FOR THE REFORM OF THE
ADMINISTRATIVE ARRANGEMENTS FOR TAXING THE SELF-EMPLOYED
AND THE BASIS OF ASSESSMENT**

A CONSULTATIVE DOCUMENT

Representations would be welcome on
the proposals discussed in this
document.

They should be sent to:

Jayne Banner
Inland Revenue
Schedule D Review
Room 3
New Wing
Somerset House
LONDON
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to arrive by 31 December 1991.



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FOREWORD BY THE CHANCELLOR OF THE EXCHEQUER

The last 12 years have seen a dramatic growth in the numbers of self-employed people - from 1.9 million in 1978/79 to 3.5 million in 1990/1991. This is a development we welcome and want to encourage.

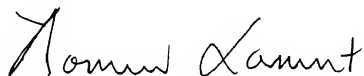
But, although we have made extensive reforms of the personal and business tax systems, we still have a system for taxing the self-employed which is complex for taxpayers to understand, and difficult for the Inland Revenue to administer. That in turn adds to the burden on taxpayers and on the Inland Revenue.

From 1993 companies will pay Corporation Tax under a new "Pay and File" system. That offers them a new streamlined system for paying tax. We believe the right next step is to overhaul the system for small businessmen and the self-employed - Schedule D.

The consultative paper makes proposals for reform. It suggests two options for changing the present basis of tax assessment, which is the largest cause of the complexity of the present system. Either of the proposed alternatives would make it simpler and more straightforward for the self-employed to pay tax on their business income and would reduce the costs of running the system. The new system would remove many of the adversarial features of the current arrangements and reduce taxpayers' dealings with the Inland Revenue.

The new system could also apply to other income which is taxed by assessment, for example income from investment or property. This could give a simpler system all round, for employees as well as for the self-employed. People would then be able to deal with the whole of their tax affairs in one go, rather than having to deal with different types of income separately as at present.

The introduction of either of the systems described in this paper would involve considerable changes for self-employed taxpayers, tax advisers and the Inland Revenue. Time will be needed for consultation, legislation and preparation for the changes. But if we are to take full advantage of this opportunity for radical and imaginative reform of the tax system, we need to plan for it now. I hope therefore that many people will send their views on the proposals to the Inland Revenue. I shall then decide how to take all this forward.

A handwritten signature in black ink, reading "Norman Lamont". The signature is written in a cursive style with a large initial 'N'.

NORMAN LAMONT

A SIMPLER SYSTEM FOR TAXING THE SELF-EMPLOYED

CHAPTER 1: INTRODUCTION

1.1 There is general agreement that the tax system should be as simple, straightforward and fair as possible, so as to reduce both the burdens on taxpayers of complying with the law and the cost of administering the tax system.

1.2 Over recent years the tax system has become simpler for the majority of taxpayers. The Government has substantially reduced the rates of tax and has introduced major reforms to the system of business taxation in 1984 and of personal taxation in 1988 and 1990. The rights and obligations of taxpayers and the powers and responsibilities of the Inland Revenue have been comprehensively overhauled following the recommendations of the Keith Committee*. And a simpler system is being introduced for the payment of corporation tax by companies.

1.3 The present systems for collecting tax by assessment have frequently been criticised for being complex and inefficient. The Keith Committee suggested that they could be made to work better by requiring returns and accounts to be delivered to the Revenue in sufficient time for assessments to be made in agreed figures. Consultations on these recommendations showed that there was widespread dissatisfaction both with the present

* Footnote The Keith Committee on the Enforcement Powers of the Revenue Departments was set up in July 1980 to enquire into the enforcement powers of the Inland Revenue and Customs and Excise. Following extensive consultations, the Government introduced legislation in the 1987 to 1989 Finance Acts based on the recommendations for income tax, capital gains tax and corporation tax in Volumes 1 and 2 of their Report (Cmnd 8822 published 23 March 1983).

system and with the approach suggested by the Committee. In the light of these responses, proposals were developed with the assistance of bodies representing business and tax advisers for a new system which would simplify and streamline the payment of corporation tax. The Government introduced this new system, known as Pay and File, in 1987 and it will start in 1993 on present plans. But they thought that it would not be sensible to try to develop similar reforms for individuals until the reforms of personal taxation in the 1988 Budget had been introduced and allowed to bed down.

1.4 This paper considers ways in which to simplify and streamline the system for taxing the self-employed. It follows a wide-ranging review of possible systems in the light of responses from the earlier consultations. The review also took account of the criticisms of the present system by the Public Accounts Committee of the House of Commons, including their criticism of the preceding year basis of assessment (PY) - under which the self-employed pay tax for the current tax year on the amount they earned in the preceding tax year.

1.5 This paper puts forward proposals for two alternative systems, the current year basis (CY) and the accounting period basis (AP). Under the CY basis tax would continue to be calculated and paid for income tax years, but the tax for a year would be based on the profits earned in that year. The AP basis would involve a more radical change under which larger businesses would make returns and pay tax for accounting periods, similar to the way in which companies pay corporation tax; smaller businesses would however have to make up their accounts, make their returns and pay tax for income tax years.

1.6 Either system would make it more straightforward for the self-employed to deal with their tax affairs and would cut the cost of running the tax system. The burdens and obligations put on the self-employed would be simplified and reduced. The complicated procedures which are needed at present to obtain

provisional payments, final payments, returns and accounts would go. Taxpayers would normally need to deal with the Revenue on only two occasions during the year - when they send in their return together with the accompanying payments and when they send in the second interim payment. Payments would normally be made in amounts determined by the taxpayer.

1.7 These reforms could also be extended to tax which is paid by assessment on income from property and investments - indeed it is doubtful whether it would be practicable to move to the AP basis without doing so. This would produce a more unified system of personal taxation under which all types of income which are taxed by assessment would be dealt with together under broadly uniform rules. A taxpayer with a number of sources of income would bring them all together in the return and pay tax on the total income, although in more than one instalment. The taxpayer would no longer have to deal with separate tax liabilities for each source of income. These changes could also apply to employees and to other income tax payers.

1.8 Some of the savings from reducing the cost of running the tax system could be used to provide a better service for personal taxpayers, for instance to provide better information and more assistance with completing their returns. And all the proposals in this paper would be of particular benefit to smaller businesses on whom compliance costs fall proportionately more heavily than on larger ones.

1.9 Any major structural reform of the tax system is likely to have some effect on the timing and the amounts of tax payments. It is the intention of the Government however that these reforms would be implemented in such a way that the changes would be broadly revenue neutral. The paper explains how this could be done by allowing some profits to go untaxed during the transition to the new system.

1.10 Chapter 2 explains the reasons for change. Chapters 3 and 4 describe how the alternative systems would work for self-employed taxpayers. Chapter 5 describes how the transition to the new systems could be handled. Chapter 6 considers how the systems would be administered. Chapter 7 considers how partnerships would be treated. Chapter 8 describes how the reforms could be extended more widely. Chapter 9 looks at some other ideas for simplifying the system for taxing the self-employed. And the annexes describe the arrangements for taxing the self-employed in other countries, look at the other proposals considered by the review of possible systems, and give a case study comparing the present system and the alternative new systems.

1.11 Views are sought on the proposals in this paper, including their effect on compliance costs where appropriate. In particular, views are sought on which of the two alternative systems, the CY or the AP basis, would provide the better system all round for self-employed taxpayers. Comments should be sent to arrive by 31 December 1991 to:

Jayne Banner
Inland Revenue
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Room 3
New Wing
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CHAPTER 2: WHY CHANGE?

2.1 Paying tax is relatively simple and straightforward for the large majority of those taxpayers who are either in employment or retired. PAYE and deduction of tax at source from investment income help to ensure that the right amount of tax is paid as income arises. And where the wrong amount is being paid, for instance because further tax reliefs are due, this can usually be put right quickly and easily.

2.2 Paying tax is more complicated and long drawn out for the self-employed. This is partly due to the type of income involved. It will always be more difficult to identify and calculate income from self-employment than income from employment, pensions and investments. But much of the added complexity comes from the way in which the present system works. This produces a large volume of correspondence, notices and demands between the self-employed taxpayer and the Revenue. Much of this uses provisional figures which have to be amended later. Many of the notices require immediate attention by the taxpayer. This all creates numerous opportunities for mistakes and misunderstandings, both by taxpayers and by the Revenue.

The present system: assessments

2.3 In the United Kingdom, as in most other countries, employees normally pay tax through deduction at source by employers when paying wages and salaries. Under the UK system of PAYE, each taxpayer is given a code which determines how much tax is deducted. When a taxpayer first starts work, the code can normally be allocated by the employer from information given by the taxpayer. The code can be updated automatically by the employer when personal allowances change. And the code can generally be changed quickly and easily by the Revenue if too much or too little tax is being paid, for instance to take account of further reliefs claimed by the taxpayer or further income reported by the taxpayer.

2.4 The new arrangements for collecting tax at source from bank and building society interest are similarly simple and straightforward. Investors who are not liable to tax can receive interest in full by completing a simple form and giving it to the bank or building society. Other investors receive interest after deduction of tax at basic rate. If too much tax has been deducted, for instance because the investor has unused personal allowances or reliefs, a repayment can be obtained by completing a simple form and sending it to the Revenue at the end of the tax year. As with PAYE, these procedures do not normally require either formal appeals to be made or returns to be checked and agreed before income can be paid in full or repayments can be made.

2.5 The present system for collecting tax by assessment is more complicated. In most cases, the Inspector of Taxes has to make an initial assessment using estimated figures as the taxpayer has not sent in the return and accounts. The taxpayer can appeal within 30 days and can apply to postpone payment of part of the tax if the estimate is too high. The amount to be postponed has to be agreed with the Inspector and the amount not postponed has to be paid. In many cases the appeal has to be listed for hearing by the Appeal Commissioners before the return and accounts are sent to the Inspector. Once the return and accounts have been sent in, they have to be considered by the Inspector and agreed with the taxpayer. If the Inspector is not satisfied with the return or the accounts, the taxpayer has to supply further information and explanations. When figures have been finally agreed, the Inspector has to amend the assessment and any balance outstanding has to be paid or repaid. There are also complicated rules for charging or paying interest on the balance.*

* Footnote In 1989/90, the Inland Revenue made approximately three million assessments for that year on self-employed taxpayers. About two million of these were estimated. And about 600,000 appeals by self-employed taxpayers were listed for hearing by the Appeal Commissioners to obtain returns and accounts.

2.6 The Keith Committee said that this system undoubtedly inflicted a great burden on the Revenue, the taxpayer, the accountancy profession and the Commissioners. They said that it was open to manipulation by the unscrupulous minority who sought to "play the system" and avoid or at least unfairly postpone payment of their true liability. They described the process as having virtually broken down with the result that the whole system was cluttered with an annual deluge of appeals and a backlog of work. The Committee suggested that the present system could be made to work better if taxpayers were required to submit returns within three months of the end of the tax year and accounts within six months of the end of the period of accounts, with automatic penalties for delay, so that assessments could normally be made in agreed figures.

2.7 Consultations on the recommendations of the Keith Committee revealed widespread concern with the present system but little support for the suggested solution. Respondents agreed that the system was complicated and inefficient. But they did not believe that the suggested time limits for submitting returns and accounts were either reasonable or feasible.

The present system: basis of assessment

2.8 The difficulties caused by the present system for collecting tax by assessment go wider than the complicated procedures for making and agreeing assessments and obtaining payments on account. Income which is taxed under PAYE or by deduction at source is taxed as it is paid, when the true amount of income is known. This is not possible for income from self-employment, which can only be measured when accounts are later drawn up; nor is it possible for other types of income taxed by assessment, for which the Revenue do not have details until the return is made after the end of the tax year. Under the present system, the assessment is therefore based on the income of the preceding tax year instead (the PY basis).

2.9 The PY basis requires complicated rules to deal with the opening years, where there is no figure of income available for the preceding year, and the closing years, where the preceding year may not provide a proper measure of income. Many taxpayers find these rules very difficult to understand. This puts burdens on taxpayers, who have to try to understand and apply the rules, and on tax advisers and the Revenue, who have to explain the rules to taxpayers and ensure that they are applied correctly. This lack of understanding tends to reduce taxpayers' confidence in the fairness of the tax system.

2.10 The PY basis means that some income is taxed twice, while other income is not taxed at all. This can work in favour of the self-employed taxpayer, as the amount which is taxed twice is generally smaller than the amount which is not taxed. To this extent it tends to discriminate unfairly between the self-employed and others who pay tax on their full income. But it can also work unfairly for the self-employed, with tax being charged on a larger figure of income than has in fact been received. This mismatch between the profits earned over the life of a business and the profits taxed under the PY basis has been criticised by the Public Accounts Committee as being inequitable.

2.11 The difficulties caused by the present system tend to increase if the taxpayer has a number of different types of income dealt with on different bases. This can mean that one tax return has to include details relating to two tax years and conversely that details for one tax year are spread over two tax returns. This makes it complicated and drawn out, both for the taxpayer and the Revenue, to settle the liability for each tax year. The problems for the taxpayer can be made worse if the different types of income are dealt with in different tax offices.

Objectives of reform

2.12 The main problems with the present system for collecting tax from the self-employed are that:

- the reliance on estimated assessments, appeals and postponements to obtain accounts and interim payments is complex, costly and inefficient;
- the present rules provide insufficient encouragement towards prompt payment;
- the PY basis and the special rules for commencements and cessations make the system very difficult for taxpayers to understand and costly and inefficient to administer;
- there is a mismatch between the profits earned and the profits assessed over the life of a business, usually but not always in favour of the self-employed taxpayer; and
- the different bases of assessment for different types of income lead to a mismatch between the assessments and the returns for a tax year, which many taxpayers find difficult to understand and which is costly and inefficient to administer.

2.13 The main objectives of the Government in proposing to reform the system for collecting tax from the self-employed are to:

- make the system easier for taxpayers to understand;
- make the system simpler and more efficient for both taxpayers and the Revenue to administer;

- make it possible for the Revenue normally to accept the return and accounts without further correspondence;
- make it possible for taxpayers normally to pay the right amount of tax at the right time without Revenue intervention; and
- open up the way for further reforms to simplify, unify and improve the system of personal taxation.

2.14 In order to achieve these objectives, differences between the systems for collecting tax from different types of income need to be reduced as far as possible. In particular, the system for collecting tax from the self-employed needs to be aligned more closely with the system for collecting tax from employees. The proposals which are discussed in the remainder of this paper are designed to achieve this. They would bring the taxes which are collected by assessment on to a common current year basis with tax paid during the tax year as income arises, broadly in line with the collection of tax under PAYE and by deduction at source.

2.15 This would open up the way for further simplification of the personal tax system, for instance by moving to a simpler system under which the only dealings which a self-employed taxpayer would normally have with the Revenue would be:

- to make a return once a year covering all the income and reliefs for the year, and
- to pay tax (which had not already been deducted at source) in one sum, although possibly in more than one instalment, on the total income for the year.

CHAPTER 3: CURRENT YEAR BASIS FOR THE SELF-EMPLOYED

3.1 Employees pay tax on the current year (CY) basis, that is they pay tax for the current tax year on the amount they earn in the year.* The self-employed pay tax on the preceding year (PY) basis, that is they pay tax for the current tax year on the amount they earned in the preceding tax year.

Example 1

An employee earns £10,000 in 1990/91, £10,500 in 1991/92 and £11,000 in 1992/93. He would pay tax for 1991/92 on income of £10,500 and for 1992/93 on income of £11,000.

Under the present rules, a self-employed taxpayer earning the same amount would pay tax for 1991/92 on income of £10,000 and for 1992/93 on income of £10,500.

Example 2

An employee earns £12,000 in 1990/91, £11,000 in 1991/92 and £10,000 in 1992/93. He would pay tax for 1991/92 on income of £11,000 and for 1992/93 on income of £10,000.

Under the present rules, a self-employed taxpayer earning the same amount would pay tax for 1991/92 on income of £12,000 and for 1992/93 on income of £11,000.

3.2 Under the CY basis, the self-employed would pay tax, like employees, on the profits they have earned in the tax year. In the above examples, the self-employed taxpayer would pay tax on the same amounts as the employee. A CY basis would mean that, as with employees, when earnings went up the increase would be

* Footnote Following changes in the 1989 Finance Act, this is normally the amount received in the tax year.

taxed for the same year and that when earnings went down the tax charge would go down for the same year too, rather than for the following year as at present.

Accounts

3.3 Earnings from self-employment are worked out from the accounts for the business. Under the present PY basis, self-employed taxpayers are allowed to make their accounts up to any date that they choose and pay tax for the tax year on the profits from the accounts ending in the preceding tax year. Under the CY basis, self-employed taxpayers would continue to be allowed to make their accounts up to any date that they chose. They would pay tax for the tax year on the profits from the accounts ending in the same tax year.

Example 3

A self-employed taxpayer makes accounts up to 30/6/90, showing profits of £10,000, and to 30/6/91, showing profits of £10,500. Under the present PY basis, she would be taxed for 1991/92 on profits of £10,000. If the CY basis applied, she would be taxed for 1991/92 on profits of £10,500.

Example 4

A self-employed taxpayer makes up accounts to 30/6/90, showing profits of £11,000, and to 30/6/91, showing profits of £10,000. Under the present PY basis, he would be taxed for 1991/92 on profits of £11,000. If the CY basis applied, he would be taxed on profits of £10,000.

Commencements and cessations

3.4 Under the present PY basis, there are special rules for the first three or four years of a business, the final three years, up to nine years when there is a change in a partnership, and up

to three years when there is a change of accounting date. These rules mean that some profits can be assessed two or three times, while other profits are not assessed at all. This also means that the total profits assessed over the life of a business are not in general the same as the total profits earned. The total profits assessed may be more, or more usually less in cash terms, than the total profits earned.

3.5 Taxpayers frequently find these special rules difficult to understand and to apply. This leads to a lack of confidence in the fairness of the tax system and puts burdens on taxpayers, tax advisers and the Revenue in trying to apply the rules correctly.

3.6 There would be no need for special rules for commencement and cessations, nor for the consequential adjustments to the computations for these years, on the new CY basis. Self-employed taxpayers would always be taxed on the profits from the accounts ending in the tax year.* This would do away with some profits being taxed more than once or not at all, which would ensure that the total profits assessed over the life of the business were the same as the total profits actually earned.

3.7 Under the present rules, many taxpayers make their accounts up to a date early in the tax year so as to give themselves longer to prepare their accounts and computations for tax purposes. This also tends to reduce the profits charged to tax for each year during the life of the business, although it may result in increased liabilities when the business ceases. The proposed new rules would allow taxpayers similarly to choose an accounting date early in the tax year. By so doing they would

* Footnote It would be for further consideration whether special rules were needed for changes of accounting date, for instance to ensure that a self-employed taxpayer would not pay tax for a tax year on the profits for a period of less than 12 months as a result of the change.

give themselves longer to prepare their accounts and computations for tax. This would also tend to reduce the profits charged to tax for each year during the life of the business, although with a corresponding increase in the profits charged when it ceased.

Example 5

A self-employed trader commences 1/10/90, makes accounts up to 30/9 annually and ceases 30/9/94. Her profits are:

Year ended 30/9/91	£10,000
Year ended 30/9/92	£11,000
Year ended 30/9/93	£12,000
Year ended 30/9/94	<u>£10,000</u>
Total profits earned	<u>£43,000</u>

She would pay tax on profits of:

<u>Tax year</u>	<u>PY basis</u>	<u>CY basis</u>
	*	
1990/91	£5,000 (1)	Nil
1991/92	£10,000 (2)	£10,000
1992/93	£11,500 (3)	£11,000
1993/94	£11,000 (3)	£12,000
1994/95	<u>£5,000</u> (4)	<u>£10,000</u>
Total profits taxed	<u>£42,500</u>	<u>£43,000</u>

* See footnote on following page.

Example 6

The facts are the same except that she makes profits of £2,000 in the year ended 30/9/94, reducing the total profits earned to £35,000.

She would pay tax on profits of:

<u>Tax year</u>	<u>PY basis</u>	<u>CY basis</u>
	*	
1990/91	£5,000 (1)	Nil
1991/92	£10,000 (2)	£10,000
1992/93	£10,000 (5)	£11,000
1993/94	£11,000 (5)	£12,000
1994/95	<u>£1,000</u> (4)	<u>£2,000</u>
Total profits taxed	<u>£37,000</u>	<u>£35,000</u>

Payment of tax

3.8 The PAYE system helps to ensure that earnings from employment are taxed as they are received during the tax year. The present PY basis similarly helps to ensure that the self-employed pay tax as they go, with the tax liability for the tax year due in equal instalments on 1 January in the tax year and 1 July following the tax year end.

3.9 Under the present system, profits from self-employment frequently have to be assessed initially using estimated figures in the absence of accounts. There are complicated procedures for securing payments on account, obtaining the return and accounts, agreeing the final liability and recovering any outstanding balance of tax and interest. These procedures put a considerable burden on taxpayers, tax advisers and the Revenue.

3.10 In order to remove the burdens caused by the present system and make the new CY basis as simple and straightforward as possible, taxpayers would normally make payments under the new system in amounts which were based on figures which they had

* Footnote (1) Section 61(1); (2) Section 61(3); (3) Section 63(1)(b); (4) Section 63(1)(a); (5) Section 60(3) Income and Corporation Taxes Act 1988.

given in their tax returns. There would in general be no need for amounts to be estimated by either the taxpayer or the Revenue.

3.11 In order to achieve a broadly similar spread of payments under the new CY basis as under the present system and to maintain parity with employees, interim payments would continue to be due on 1 January in the tax year and 1 July after the year end, with the balance due with the return on the following 1 January. As the interim payments would be due before the income for the current year might be known, they would be based on the tax paid for the preceding year. This would be similar to the present system for taxing income from property. It would also be similar to the systems for taxing the self-employed in other countries.

3.12 Under the CY basis a self-employed trader:

- would make interim payments on 1 January in the tax year and 1 July following the tax year, each equal to one-half of the liability from self-employment in the previous year;
- would deliver the return for the current year to the Revenue together with the accounts, tax computations and payment of any balance outstanding by 1 January following the tax year end; and
- the final liability shown in the return would determine the first interim payment for the following year, which would also be due with the return.

Example 7

A self-employed taxpayer has a final tax liability for 1995/96 of £3000 and for 1996/97 of £3300. On the CY basis, she would pay tax for 1996/97 as follows:

1/1/97	First interim	£1,500
1/7/97	Second interim	£1,500
1/1/98	Final balance	£ 300

Her total payment on 1/1/98 would be £1,950 as she would also pay the first interim payment for 1997/98 of £1,650 on that date.

Falling tax liabilities

3.13 Self-employed taxpayers would be allowed to reduce their interim payments if their current year's liability was likely to be less than the previous year's, but not below half the liability for the current year for the first interim payment or the whole of the liability for the two payments together.

3.14 This would allow a self-employed taxpayer to obtain an immediate reduction in tax payments if profits go down. This only happens under the present PY basis if the business starts to make a loss.

Example 8

If the taxpayer in the above example has a final liability for 1996/97 of £2,000, she would be able to reduce the payments for 1996/97 as follows:

1/1/97	First interim	£1,000
1/7/97	Second interim	£1,000
1/1/98	Final balance	Nil

New businesses

3.15 There would be no interim payments in the first year of self-employment, as there would be no liability for the previous year.

Example 9

A taxpayer commences self-employment in 1995/96 and makes up his accounts for the tax year. His final liability from self-employment is £2,000 for 1995/96 and £4,000 for 1996/97. Under the CY basis, he would pay tax as follows:

1/1/96	First interim 95/96	Nil
1/7/96	Second interim 95/96	Nil
1/1/97	Final balance 95/96	£2,000
	+ First interim 96/97	£1,000
1/7/97	Second interim 96/97	£1,000
1/1/98	Final balance 96/97	£2,000
	+ First interim 97/98	£2,000

3.16 Under the CY basis, a self-employed taxpayer would be able to choose to make up the first accounts of a new business for a period ending in the second tax year of the business. The effect would be to reduce the liability for the first year to nil and possibly to reduce the liability for subsequent years, although with a corresponding increase in the liability when the business ceased. The cash flow benefits could be of assistance to new businesses and help to encourage more new businesses to be set up.

Example 10

The facts are the same as in Example 5 above, ie the taxpayer commences self-employment on 1/10/90 and makes up accounts to 30/9 annually. If the CY basis applied, she would not pay any tax until 1/1/93. She would then pay the final balance for 1991/92 on profits of £10,000 together with the first interim for 1992/93 (which would be equal to half the final balance for 1991/92).

Production of returns and accounts

3.17 The time limit of 1 January after the year end for the delivery of the return, accounts and tax computations to the Revenue is the latest which is practicable if, as proposed, all payments are to be made in figures returned by the taxpayer. This would give taxpayers 9 months to prepare the return and between 9 and 21 months to prepare the accounts, depending on the accounting date chosen. In the consultations on the recommendations of the Keith Committee, bodies representing the accountancy profession suggested that taxpayers should be allowed 12 months to prepare accounts. The proposed filing date for the accounts and tax return could be seen as a reasonable compromise. This would allow taxpayers more than 12 months to prepare their accounts if they chose, while enabling them to make all payments using figures which they had returned.

Computation of the tax liability

3.18 Under the present system, taxpayers have to compute their income for tax and include details of this in their tax returns. But their tax liabilities are worked out by the Revenue. Under the CY basis, self-employed taxpayers would have to compute their own tax liabilities and include details of these in their tax returns. This is necessary in order to allow taxpayers as long as possible to send their returns and accounts to the Revenue. (Tax returns and accounts would need to be sent to the Revenue well before 1 January if the Revenue had to compute the liability before the first interim payment became due on 1 January.)

3.19 Many tax advisers already prepare tax computations for their clients and frequently send these to the Revenue with the return. For these taxpayers, computing their own liabilities would not put any additional burdens on them, while the other changes which this makes possible would reduce their burdens.

3.20 The rules proposed for the CY basis would make it reasonably straightforward for all self-employed taxpayers to compute their own tax liabilities. Under the new system, it is likely that most taxpayers and tax advisers would prefer to do this as it would reduce the need for correspondence with the Revenue and the opportunities for mistakes and misunderstandings. This would also give taxpayers greater certainty as they would normally know their final liability once they had completed their returns.

3.21 There may however be some taxpayers, for instance very small businesses which do not have professional advisers, who would prefer to have their tax liabilities computed for them by the Revenue under the new system. It might be possible for this service to be provided where the completed return and accounts, showing the income for the period covered by the return, reached the Revenue sufficiently early. It would be for further consideration when the return and accounts would be needed, but this might for instance be by 30 September following the tax year end (ie within six months of the end of the tax year). The Revenue would then send the taxpayer a computation of the tax liability, using the figure of income given by the taxpayer, by 1 January so that the taxpayer could pay the balance outstanding and the first interim payment for the next tax year at the correct time.

Summary

3.22 Views are sought on the CY system. The key features are:

- self-employed taxpayers would pay tax for the tax year on the profits from the accounts ending in the tax year (paragraph 3.3)
- they would make interim payments on 1 January and 1 July equal to half the liability for the previous year, and file the return and accounts and pay the balance on the following 1 January (paragraph 3.12)

- there would be no special rules for commencements and cessations (paragraph 3.6)
- taxpayers who wanted to have their liability computed by the Revenue would have to file earlier (paragraph 3.21).

CHAPTER 4: ACCOUNTING PERIOD BASIS FOR TAXING THE SELF-EMPLOYED

4.1 Under the present PY basis, much of the work of dealing with the tax affairs of the self-employed is seasonal for tax advisers and the Revenue, with work concentrated into the period up to the beginning of December, in which estimated assessments are issued and payments on account agreed, and around the payment dates at the beginning of January and July. The proposals for the CY basis in Chapter 3 would concentrate work further with returns, accounts and tax computations due from all self-employed taxpayers by 1 January and all payments due on 1 January and 1 July. Some of the respondents in the consultations on the recommendations of the Keith Committee suggested that it might therefore be better if the self-employed paid tax for accounting periods (AP), rather than tax years, in the same way as companies pay corporation tax.

4.2 It was suggested by these respondents that the AP basis would be easier for both tax advisers and the Revenue as it would spread work through the tax year. They also suggested that it would be more equitable, as the average interval between the time when profits were earned and the time when tax was paid would be the same for all taxpayers. By contrast, the CY basis would allow self-employed taxpayers to increase the interval by choosing an accounting date earlier in the tax year, although with a resulting increase in their tax liability when they ceased in business.

Tax returns and tax computations

4.3 Under the CY basis, the return and tax computations would be for a tax year. The return would show the profits from the accounts ending in the tax year as the income from self-employment. Other types of income would be returned showing the income arising in the tax year itself and allowances and reliefs would similarly be claimed for the tax year. The tax liability for the tax year would be computed using these figures.

4.4 Under the AP basis, the return would be made for an accounting period of the business. All income, including income other than from the business, would be returned showing the income arising in the accounting period, rather than a tax year, and allowances and reliefs would similarly be claimed and tax computed for the accounting period. As with computations of corporation tax when rates and bands change, tax would normally need to be computed separately for the parts of the accounting period falling into separate tax years.

4.5 The tax computations for these part periods would use details of the actual income and reliefs for the part period where possible. Where amounts would normally be determined by reference to a period of accounts or a tax year, including personal allowances and rate bands, these would have to be apportioned on a time basis to determine the amounts for each part period.

4.6 The tax return and the computations would be more complicated on the AP basis than on the CY basis. Some simplification might be possible by making apportionments by reference to numbers of months, rather than days. But the computations would still be complex, particularly for taxpayers with other income, for example from employment, from self-employment with a different accounting date, or as a Lloyd's underwriter; for taxpayers with capital gains; for taxpayers claiming relief for contributions to a personal pension or a retirement annuity; and so on.

4.7 This added complexity would also reduce the flexibility of the personal tax system, by comparison with the CY basis, to allow changes to be made in the future, for instance to allow new types of personal reliefs to be introduced.

Special rules

4.8 Accounting periods would normally be 12 months long. Procedures would be needed to ensure that the Inspector and the

taxpayer agreed a move to the AP basis, or a change of accounting date, in advance so that the Inspector would know when returns and payments would be due.

4.9 Special rules would be needed to deal with changes from the tax year basis to the AP basis (for instance where a person started in self-employment), changes from the AP basis to the tax year basis (for instance where a person ceased self-employment), and changes of accounting date.

4.10 These changes could be handled without income needing to be taxed twice or not taxed at all by treating the intervening periods between the changes of basis as if they were separate APs.

Example 1

A taxpayer becomes self-employed on 1/10/96 and makes up accounts for the business to 30/9. He would be taxed for:

- the tax year 1995/96
- the intervening period 6/4/96 to 30/9/96
- the AP 1/10/96 to 30/9/97, etc.

Example 2

A self-employed taxpayer who normally makes up the accounts for the business to 30/9 ceases self-employment on 30/6/97. She would be taxed for:

- the AP 1/10/95 to 30/9/96
- the AP 1/10/96 to 30/6/97
- the intervening period 1/7/97 to 5/4/98
- the tax year 1998/99 etc.

Payments and returns

4.11 There are two main approaches possible for setting the due dates for making returns and payments on the AP basis so that the flow of tax payments would be broadly the same as at present and so that all payments would be made using figures returned by the taxpayer.

4.12 Payments could continue to be made in two main instalments with interim payments for the AP, 9 months and 15 months after the start of the AP, equal to half the final liability for the previous AP. This would mean that the return, accounts and payment of the balance would have to be sent to the Revenue 9 months after the end of the AP.

4.13 Alternatively, 12 months could be allowed for making the return. This would mean that payment would have to be made in one main instalment with an interim payment for the AP, 12 months after the start of the AP, equal to the final liability for the previous AP. The return, accounts and balance of the tax would be sent to the Revenue 12 months after the end of the AP.

Smaller businesses

4.14 Tax computations would be more complicated on the AP basis than on the CY basis. They would probably be too complicated for smaller businesses because of the burdens they would put on the taxpayer to produce the computations and on the Revenue to check them. The treatment of the part periods before a business started and after it finished would also cause difficulties for small businesses and the Revenue. The regulations which would be needed to ensure that the Revenue knew when payments and returns would be due would also be burdensome for small businesses.

4.15 For these reasons, it is doubtful whether a true AP basis would be suitable for smaller businesses. This could be handled

by allowing larger businesses to make up their accounts to any date that they chose, but requiring smaller businesses to make up their accounts for the tax year (either to 31 March or to 5 April), so that they would continue to make their returns and pay tax for tax years rather than APs.

4.16 One way of doing this might be to define the businesses which were allowed to use simplified accounts for tax purposes (see paragraph 6.7 below) so that these were the same ones as were required to make up their accounts for the tax year. These taxpayers would therefore be required to make their returns and pay tax for the tax year. Businesses could be allowed to move to the AP basis if they grew above the size allowed to use simplified accounts, with the change from the tax year basis to the AP basis handled as described in paragraph 4.10 above. But it would follow that a significant proportion of the self-employed would remain on a tax year basis if the AP basis were introduced, which would limit the extent to which this would spread work for tax advisers and the Revenue.

Summary

4.17 Views are sought on whether the advantages of the AP basis, as compared with the CY basis, outweigh the disadvantages and on the detail of how the AP basis might work. The key features are:

- self-employed taxpayers would pay tax for accounting periods on the whole of their income (paragraph 4.4)
- they would make interim payments 9 and 15 months after the start of the AP equal to half the liability for the previous AP, and file the return and accounts and pay the balance 9 months after the end of the AP (paragraph 4.12)
- or, alternatively, they would make one interim payment 12 months after the start of the AP equal to the

liability for the previous AP, and file the return and accounts and pay the balance 12 months after the end of the AP (paragraph 4.13)

- smaller businesses would have to make their accounts up to 31 March or 5 April (paragraph 4.16).

The transition to the CY basis

5.1 Under the present PY basis, self-employed taxpayers normally pay tax for a tax year on the profits for a corresponding period of 12 months. Under the proposals for the CY basis, tax would in general continue to be paid for a tax year on the profits for a corresponding period of 12 months. Tax would also continue to be paid on broadly the same payment dates, with most of the tax for the tax year being due in two instalments on 1 January in the tax year and 1 July following the year end.

5.2 It would be possible to move straight from the PY basis to the CY basis at transition. The profits for the intervening period of accounts would be left untaxed.

Example 1

A self-employed taxpayer makes accounts up to 30/6. If the CY basis were to start on 6/4/95, she would be taxed for 1994/95 (the last PY year) on her profits from the accounts to 30/6/93. She would be taxed for 1995/96 (the first CY year) on her profits from the accounts to 30/6/95. The profits from the accounts to 30/6/94 would not be taxed.

The pattern of payments would continue broadly unchanged. She would pay tax for 1994/95 (the last PY year) in two instalments on 1/1/95 and 1/7/95. She would pay tax for 1995/96 (the first CY year) in two main instalments on 1/1/96 and 1/7/96.

5.3 Some self-employed taxpayers might wish to change the date they make their accounts up to at the transition. They could be taxed then for the first CY year on their profits for the 12

months up to the new accounting date, which could be calculated by apportioning the profits from the periods of accounts if necessary.

Example 2

The taxpayer in Example 1 decides to move her accounting date to 30/4 for the CY basis. She would be taxed for 1995/96 on her profits for the 12 months to 30/4/95. The profits for the period 1/7/93 to 30/4/94 would not be taxed.

Example 3

The facts are the same except that she decides to change her accounting date to 31/3. She would be taxed for 1995/96 on her profits for the 12 months to 31/3/96. Her profits for the period 1/7/93 to 31/3/95 would not be taxed.

Profits left untaxed

5.4 Profits are similarly left untaxed on the PY basis when a business ceases. The broad effect of these proposals would be to bring forward to the transition the dropout which would occur under the present rules on a subsequent cessation.

5.5 The present rules limit the profits which drop out of assessment by taxing the penultimate two years on the profits actually earned in that period if they are greater than the profits which would otherwise be taxed on the PY basis. A similar provision would be needed for the transition to prevent excessive profits being left out of assessment. This might for instance be done by taxing the first year of the CY basis on the CY or the PY basis, whichever was greater, or on the average of the profits during the transitional period. Alternatively, the revision to the PY basis might be limited to cases in which profits had been deliberately diverted into the period which

would normally be left untaxed. On the one hand, a general provision might be seen as fairer and more objective. On the other hand, a more limited provision depending on an avoidance test would substantially reduce the number of cases in which adjustments would need to be considered, although at the expense of a more subjective motive test.

Transitional relief

5.6 A business which ceased shortly after the transition might be taxed under these proposals on more profits than would have been taxed if the old rules had continued to apply.

Example 4

In Example 1 above, under the CY basis the taxpayer would be taxed for 1995/96 on her profits for the period from 1/7/94 to 30/6/95.

If she ceased in business on 30/6/95 and the old rules had continued to apply, she would have been taxed for 1995/96 on her profits for the period from 6/4/95 to 30/6/95 only.

If the old rules had continued to apply, her tax liabilities for 1993/94 and 1994/95 might also have increased which would limit or reverse the effect of the reduction in the profits which would have been taxed for 1995/96.

5.7 Any business which makes up its accounts for the first CY year to a date before the end of the tax year will be taxed for that year on some profits which were earned before the start of the new system. It is appropriate to consider whether some form of transitional relief should be allowed where this happens. Any relief should be limited however, as the accounting date is a matter of choice for the taxpayer and the use of a date early

in the tax year, which increases the profits in question, can also have advantages for the taxpayer who thereby defers the payment of tax on profits.

5.8 Transitional relief might for instance be given to businesses which ceased during the first six years of the CY basis. The relief could be based on the profits which were taxed for the first CY year but which were earned before the start of that year, after taking account of any provisions limiting the profits left untaxed at the transition (see paragraph 5.5 above), and given by reducing the taxable profits for the year in which the business ceased. Relief might for instance be given for this amount in full where a business ceases during the first year of the CY basis and given on a tapering basis where it ceases within the next five years.

Example 5

The facts are the same as in Example 1. If the business ceased on 30/6/95, the profits taxed for 1995/96 would be restricted to the profits for the period from 6/4/95 to 30/6/95.

Example 6

The facts are the same as in Example 1. If the business ceased in 1999/2000 (the fifth CY year), the profits taxed for 1999/2000 would be reduced by one-third (ie two-sixths) of the profits for the period 1/7/94 to 5/4/95.

The transition to the AP basis

5.9 The transition from the PY to the AP basis would work slightly differently. This would again involve a straight change from the old basis to the new with the profits for the intervening period left untaxed. Where the taxpayer made accounts up to a date before the end of the tax year, tax would be due earlier on the AP basis than on the CY basis. This could

be balanced by making the first period of the new basis the period from the date of transition to the next accounting date. There would then be no need for a transitional relief.

Example 7

In Example 1 above, she would be taxed for 1994/95 on her profits from the accounts to 30/6/93. The first AP would be from 6/4/95 to 30/6/95. Her profits for the period from 1/7/93 to 5/4/95 would not be taxed.

Payment of tax during the transition

5.10 It would not be practicable for the new rules on interim payments and for making the system work (see Chapter 6) to start until the second year of the new system, as there would not be a returned figure available in the first year for the liability of the preceding period. The first year of the CY basis might therefore be dealt with under the present procedures, with the Inspector making an estimated assessment of the amount due for that period and postponement applications being allowed if the estimate was too high.

5.11 The transition to the AP basis would be more complicated. The first two accounting periods would probably need to be dealt with under the present procedures. There would also need to be special rules for the dates of payment for the first accounting period (which would normally be less than 12 months) in order to keep the cash flow of tax payments broadly unchanged.

Tax returns and accounts

5.12 Self-employed taxpayers are normally sent a tax return each year to complete and return to the Revenue, together with accounts and tax computations for the business. Many self-employed taxpayers are seriously behind with sending their returns and accounts to the Revenue and would need to get up to date for the start of the new system. It is therefore

appropriate to consider whether there are any special measures which might be needed to help them to achieve this.

5.13 One approach might be for businesses to prepare a single set of accounts covering the period which would be left untaxed and the first period of the new system if they chose rather than separate accounts for these periods. The profits for the first period could in general be worked out by apportioning the profits from the accounts on a time basis.

5.14 Another possible approach, if it were felt that this would be fair to other taxpayers, might be to allow smaller businesses with straightforward affairs to dispense with the production of accounts for the period which would be left untaxed. But they would have to keep records for this period and might be required to prepare simplified summaries from them, for instance if the Inspector was not satisfied with their returns.

Summary

5.15 Views are sought on the proposals discussed in this chapter. The main features are:

- letting profits go untaxed at transition (paragraph 5.2)
- whether the provision needed to limit the profits left untaxed should be general or limited to avoidance (paragraph 5.5)
- transitional relief (paragraph 5.8)
- helping smaller businesses get up to date by producing combined accounts for the dropout and the next period or possibly by dispensing with accounts for the dropout period (paragraphs 5.13 and 5.14).

CHAPTER 6: MAKING THE SYSTEM WORK

6.1 The introduction of the new system would simplify and streamline the system for taxing the self-employed. The burdens and obligations put on the self-employed trader would be simplified and reduced. The complicated procedures which are needed at present to obtain provisional payments, final payments, returns and accounts would go. Taxpayers would normally need to deal with the Revenue on only two occasions during the year, when they send in the return and accompanying payments and when they send in the second interim payment. All payments would normally be made in amounts determined by the taxpayer.

6.2 The present system requires a high degree of regulation and supervision by the Revenue. The new system would remove many of the more burdensome and adversarial features of this system. It would accept that the majority of taxpayers are law-abiding citizens who, given fair and sensible rules, could be trusted to pay their taxes and send their returns and accounts to the Revenue at the right time. Other countries which have similar systems experience very high levels of voluntary compliance by taxpayers in making returns and paying tax at the right time.

6.3 But in order for this type of system to work efficiently and effectively, and to ensure that the minority of taxpayers who try to delay or evade payment of their taxes are not able to gain an unfair advantage over the majority of taxpayers who comply voluntarily with their obligations, there must be effective checks and controls against late and inadequate payments of tax and late filing of accounts and returns.

Checking returns and accounts

6.4 Under the present system, all returns and accounts have to be reviewed by the Revenue and the figures agreed with the

taxpayer. If the Inspector is not satisfied with the return, the taxpayer has to supply further information and explanations before the figures can be agreed.

6.5 The new system would do away with the need for returns and accounts to be reviewed in every case, and for further information and explanations to be called for where the Inspector is not satisfied. Under the new system the interim and final payments would be made in amounts which were determined by the taxpayer. There would normally be no need for the figures to be agreed with the Revenue. Similarly, where the taxpayer chose to file the return early to have the liability computed by the Revenue, this would be calculated using the figures given by the taxpayer in the return. These figures would not normally be checked or agreed by the Revenue first.

6.6 The Revenue would still need to review returns, accounts and tax computations in some cases. In order to maintain equity between taxpayers and to allow errors and omissions to be detected, all returns, accounts and tax computations would have to be capable of being chosen for audit by the Revenue - for instance to check particular entries or to review the return more generally. But the number of cases in which further adjustments, enquiries and correspondence were needed to settle the tax liabilities would be very much lower than under the present system.

Simplified accounts

6.7 Very small businesses are allowed to use simplified "three line" accounts for their tax returns. At present this applies where the turnover of the business does not exceed £10,000. The Chancellor of the Exchequer announced in his 1991 Budget Speech that the level will be increased for returns sent in after 5 April 1992.* The introduction of the new system might allow

* Footnote Hansard, 19 March 1991, col 170.

this relaxation to be extended more widely so that a larger proportion of self-employed taxpayers would be able to send in simplified accounts with their tax returns. Self-employed taxpayers would still need to keep records and to retain them for up to six years (or four years if the proposal in paragraph 6.10 below were adopted) and these records would be audited by the Revenue in some cases. Larger businesses would continue to provide detailed accounts with their returns. But extending the scheme more widely could help to reduce burdens for many small businesses.

Time limits for amending returns

6.8 The new system would give taxpayers greater certainty over their liabilities when they make their returns. Payments would be made in amounts computed by the taxpayer. In most cases, that would be the end of the matter. But in some cases, the return would subsequently be chosen for audit and, if it was found to be incorrect, a repayment or further tax might be due.

6.9 The right of the Revenue to select any return, accounts and tax computations for audit could be seen as reducing certainty for taxpayers to some extent. It is for consideration whether this should therefore be balanced by reducing the time within which the Revenue could amend the return. Under the present system, the Revenue is normally allowed to make assessments up to six years after the end of the tax year. This is extended to 20 years for assessments to recover tax lost through fraudulent or negligent conduct.

6.10 There is an important question of balance to be considered. Sufficient time must be allowed for returns to be made, including late returns, for returns to be selected for audit and for audits to be made. It might be possible to reduce the time limit for making assessments, for instance to four years from the end of the tax year, other than in cases of fraudulent or negligent conduct for which it would remain as 20 years. But

the time limit for taxpayers to amend returns, for instance to correct errors and mistakes or to claim further allowances and reliefs, would need to be reduced likewise.

Controls for late payments and returns

6.11 The controls for late payments and returns should naturally follow the same broad pattern as has been established generally for the direct taxes in the legislation based on the recommendations of the Keith Committee, which was completed in the 1989 Finance Act, that is:

- interest or surcharges, subject to mitigation by the Revenue, for late payments,
- non-mitigable penalties, subject to reasonable excuse appeals, for late returns, and
- fully-mitigable penalties for culpable offences which put tax seriously at risk.

6.12 There is a question of balance here between the two regulatory controls, surcharges for late payments and penalties for late returns. The main objective of the new system would be to ensure that the right amount of tax was paid at the right time. It would therefore seem reasonable to tilt the balance towards surcharges for late payments, rather than penalties for late returns, and to relate the surcharge principally to the amount of tax unpaid.

Surcharges for late payments

6.13 Under the new system payments of tax would normally be made in amounts determined by the taxpayer. In order to encourage the payment of the right tax at the right time, it is suggested that where the tax determined by the taxpayer is paid late, there would be an automatic surcharge on the tax paid late. The

surcharge would need to be at a level which was sufficient to ensure a high degree of voluntary compliance in the payment of tax but which was not unduly severe on taxpayers who pay late. 10 per cent might be a reasonable figure to achieve this balance.

Example 1

The facts are the same as in Example 7 in Chapter 3 (ie first interim payment of £1,500 due on 1/1/97). If the taxpayer paid £500 on 1/1/97, she would be liable to a surcharge of £100 on the £1,000 unpaid.

Example 2

The facts are the same as in Example 8 in Chapter 3 (ie first interim payment due on 1/1/97 could be reduced to £1,000). If the taxpayer paid £500 on 1/1/97, she would be liable to a surcharge of £50 on the £500 unpaid.

6.14 The surcharge would depend only on whether the right amount of tax, as determined by the taxpayer, had been paid at the right time. The relevant factors on which the surcharge would depend would be broadly the same as for interest charges on late payments of tax. When the rules for charging interest and default interest were revised in the legislation based on the recommendations of the Keith Committee, the Government decided that it would be inappropriate to allow appeals against interest charges on grounds of reasonable excuse as it was doubtful whether there were grounds which it would be proper for the Commissioners to consider. For instance, they concluded that an insufficiency of funds should not of itself be a reasonable excuse for failing to pay tax at the right time. But it was decided that the Revenue should be allowed the discretion to mitigate the charge in part or in full where appropriate, for instance to allow administrative de minimis limits, to allow the

flexibility to deal with problems such as delays in the post and to deal with cases of financial hardship. Appeals would similarly not be allowed against the surcharge on grounds of reasonable excuse but the Revenue would have discretion to mitigate the surcharge where appropriate.

Interest on late payments and repayments of tax

6.15 There would probably need to be an interest charge as well if the tax and surcharge remained unpaid. As now, this could be based on a broad average of the net of tax cost of borrowing for an average taxpayer and run from the due date until the tax was paid.

Example 3

In Example 1 above, interest would be charged on the unpaid tax and surcharge, ie £1,100, from 1/1/97 until this was paid.

6.16 Interest could also be paid on overpayments of tax from the due date until the tax was repaid, although this would probably need to be at a lower rate to reflect the average net of tax return on deposits for an average taxpayer.

Example 4

The facts are the same as in Example 8 in Chapter 3 (ie taxpayer can reduce her interim payments for 1/1/97 and 1/7/97 to £1,000). If the taxpayer did not reduce her interim payments, making payments of £1,500 on 1/1/97 and 1/7/97, she would be entitled to a repayment of £1,000 with interest from 1/1/97 on £500 and from 1/7/97 on £500.

6.17 As with the surcharge, it would not be appropriate to allow appeals against the interest charge on grounds of reasonable excuse. But the Revenue would have discretion to mitigate the interest in part or in full where appropriate - for instance to

allow for time in the post, for cases of financial hardship and, by imposing administrative de minimis limits, so as to restrict the charge to cases where the amount of tax unpaid was larger or the length of delay was more serious.

Controls for late filing

6.18 The interest and surcharge would help to ensure that the right payments were made at the right time. This should reduce the need for penalties to discourage taxpayers from delaying their returns and accounts. But the Revenue would still need to see returns and accounts, even where the right tax had been paid. So a penalty would be needed for late filing. A penalty of £100, increasing to £200 if the return was not made within a further six months, combined with the surcharge of 10 per cent on tax paid late, might be sufficient to encourage a high degree of voluntary compliance in the filing of returns and accounts without being unduly severe on taxpayers who file late.

6.19 As with other similar provisions for automatic penalties, the late filing penalty could be reduced to nil by the Inspector or by the Commissioners on appeal where there was a reasonable excuse for the delay. But in order to avoid giving an unfair advantage to taxpayers who delayed payment of the late filing penalty or disputed the penalty without adequate cause, the penalty would have to be paid before an appeal could be made for reasonable excuse.

Incorrect returns

6.20 Where a return was amended, either by the Inspector following an audit or by the taxpayer, further tax might be found to be due for payment by the taxpayer or tax might be found to be due for repayment to the taxpayer. Interest would be charged or paid on the tax from the original due date until it was paid or repaid. But there would be no surcharge or penalty where further tax was found to be due, except where tax had been underpaid through fraudulent or negligent conduct. In

particular, the surcharge for late payment would not apply to underpayments made as a result of an innocent error in a return.

6.21 There would be no need for any change in the way in which fraud and negligence are tackled. Estimated assessments would be able to be made where necessary. As now, there would also be a fully-mitigable penalty of up to the amount of tax underpaid.

6.22 Similarly, as now there would be a fully-mitigable penalty of up to the amount of tax underpaid for other culpable offences which put tax seriously at risk, such as failure to notify chargeability and persistent failure to make a return. The Inspector would also be able to make estimated assessments where they were needed to tackle these problems.

Summary

6.23 Views are sought on the proposals discussed in this chapter. The main features are:

- doing away with the present complicated procedures for obtaining provisional payments, filing of returns and accounts and agreeing liabilities (paragraphs 6.1 to 6.6)
- increasing the limits for simplified accounts (paragraph 6.7)
- reducing time limits for making assessments and amending returns (paragraph 6.10)
- surcharge for late payment (paragraph 6.13)
- mirror image interest (paragraphs 6.15 and 6.16)
- penalties for late returns (paragraph 6.18).

CHAPTER 7: PARTNERSHIPS

7.1 Under the present PY basis, partnerships are generally taxed on a joint basis. The tax due on the trading profits of the partnership is assessed in a single sum and can be collected from any of the partners.

7.2 Joint assessment simplifies the collection of tax on trading profits, which has advantages for the partners and for the Revenue. But it also makes the procedures for determining the tax liabilities of the partners more complex and means that complicated rules are needed to deal with changes in the partnership.

7.3 The new system would simplify and streamline the collection of tax which would shift the balance of advantage away from joint assessment. There would therefore be a case for changing the rules so that partners would pay tax under the new system on their own share of the partnership profits. In that event, there would be no joint liability for tax on partnership profits except possibly in relation to non-resident members.

7.4 There would however need to be arrangements to allow the profits of a partnership to be audited by the Revenue and to be agreed with the partners jointly.

7.5 Under the present system, a partnership can choose whether to be treated as if the business had ceased and recommenced or as if the business had continued when a partner joins or leaves the partnership. Under the new system, there would not be the same need for a choice of treatment. It would probably be simpler if changes in a partnership were ignored for tax, treating the business as if it continued.

Allocation of partnership profits

7.6 Tax is worked out on the trading profits of a partnership by dividing the profits between the partners and working out the

tax due on each partner's share. Under the present system, profits are divided on the basis of the partners' respective shares in the profits for the tax year which is being assessed, rather than the period in which the profits were earned. This can give rise to difficulties, for instance where the way in which the profits are shared has changed or where an incoming partner has to pay tax on profits which he has not received. It also complicates the tax computations and lengthens the time before the details needed to settle the partners' tax affairs become available.

7.7 On the AP basis, profits would be taxed for the same period as the profits were earned. Profits would therefore be divided for tax on the basis of the partners' respective shares in the profits for the accounting period in which the profits were earned.

7.8 On the CY basis, there would be some mismatch between the period for which the profits were taxed and the period in which the profits were earned. It might therefore be more sensible to divide profits for tax on the basis of the partners' shares in the profits for the period of accounts in which the profits were earned, rather than the tax year, as this would be both fairer and more straightforward than the present rule.

Example

A partnership makes up accounts to 30/6. The partners are taxed on the CY basis for 1996/97 on the profits for the year ended 30/6/96.

Under the present rule, the profits would be divided between the partners on the basis of their shares in the profits of the partnership for the year ended 5/4/97.

Under the proposal, the profits would be divided between the partners on the basis of their shares in the profits of the partnership for the year ended 30/6/96.

Scottish partnerships

7.9 These new rules would apply to partnerships governed by Scottish law in the same way as they would apply to partnerships governed by English law.

Further consultations

7.10 If the Government decides to introduce the new system, there would need to be further consultations with professional bodies to consider detailed aspects of the treatment of partnerships. One area which would need to be examined is whether the proposals for changing the way in which profits are divided for tax would cause difficulties for some existing partnerships and if so how this should be handled.

Summary

7.11 Views are sought on the proposals discussed in this chapter for:

- separate assessment of partners (paragraph 7.3)
- automatic continuation treatment (paragraph 7.5)
- accounts basis for apportioning profits (paragraph 7.8).

CHAPTER 8: A MORE UNIFIED SYSTEM

8.1 This chapter considers how other types of income which are taxed by assessment could be brought into the new system to give a more unified system for all personal taxpayers, including employees and other income tax payers as well as the self-employed.

The CY basis

8.2 The proposals in Chapter 3 for the CY basis looked at the taxation of income from self-employment. Under the CY basis, a self-employed taxpayer would pay tax for the tax year on the amount earned from the business in the accounts ending in the tax year. The final balancing payment for the tax year and the interim payments for the following tax year would be based on the tax due on this amount.

8.3 It would be possible to continue to deal with other income under the present rules, retaining the procedures for making assessments and agreeing payments on account and the various different rules on the basis of assessment for different types of income. But this could negate the savings from simplifying the system for the minority of self-employed taxpayers who have other types of income as well.

8.4 A better alternative might be to bring all income on which tax is paid by assessment into the new system. At present different types of income are dealt with separately and according to different rules. Under this proposal all income would be taxed on the CY basis and dealt with together in one go. Income from self-employment would be taxed on the profits from the accounts ending in the tax year. Other types of income would be taxed on the income arising in the tax year. The net tax due for the year, after giving credit for any tax deducted at source*,

* Footnote Including tax credits on dividend income.

would be computed in a single sum on the total income for the year. And tax would be paid on the total income, rather than paying tax separately on each source of income. The final balancing payment on the CY basis for the tax year and the interim payments for the following year would be based on the net tax due on the total income for the year.

8.5 Investment income of employees and pensioners is taxed by deduction at source and through the PAYE system as far as possible. But investment income which cannot be fully taxed in this way has to be taxed by assessment. Employees and pensioners paying tax on investment income by assessment could also be brought into the new system in the same way, so that there would be uniform rules for all income taxed by assessment. Trusts and other bodies paying income tax by assessment could also be brought into the new system likewise.

The AP basis

8.6 It is doubtful whether it would be practicable to move to the AP basis without bringing all income on to the same basis, because of the complications which would be caused if some income were taxed for accounting periods and some for tax years. Under the AP basis, the self-employed taxpayer would make a single return for each accounting period which would include all the income arising in that period, both from the business and from other sources, and the reliefs and allowances for that period. The final balancing payment for the accounting period and the interim payments for the following period would be based on the tax due on the total income in the return.

8.7 Under the proposals for the AP basis, smaller businesses would make up their accounts and pay tax for tax years rather than for accounting periods, like employees and pensioners. Smaller businesses could similarly pay tax on the total income arising in the tax year, which would form the basis for the final balancing payment for the year and the interim payments for the following tax year. Employees and pensioners who pay tax

on investment income by assessment and trusts etc could also be brought on to the same basis.

Payment dates

8.8 Under the present system, tax on investment income which is received gross of tax is due in one instalment on 1 January in the tax year. Higher rate tax on investment income which is received net of tax is due in one instalment on 1 December after the tax year end. If other income which is taxed by assessment were brought into the new system, so that all tax payments would be based on the total income for the year, the broad effect would be for tax to be paid later than at present on investment income received gross and earlier than at present for higher rate tax on investment income received net of tax.

Example 1

A self-employed trader also pays tax on interest received gross and higher rate tax on dividends as follows:

	<u>1995/96</u>	<u>1996/97</u>
Trade	£10,000	£10,500
Interest	£ 1,000	£ 1,100
Dividends	<u>£ 2,000</u>	<u>£ 2,200</u>
Total	<u>£13,000</u>	<u>£13,800</u>

Under the present rules, ignoring differences in the basis of assessment, he would pay the tax for 1996/97 on the interest on 1/1/97 and on the dividends on 1/12/97.

If other income which is taxed by assessment were brought into the new system, he would pay tax for 1996/97 as follows:

1.1.97	First interim	£6,500
1.7.97	Second interim	£6,500
1.1.98	Final balance	£ 800

Transition to a more unified system

8.9 Some types of investment income which are received gross are taxed on a CY basis already (eg income from property, bank and building society interest paid gross under the new arrangements). These types of income could move straight to the new system at transition without any income needing to be left untaxed or taxed twice.

8.10 Other types of investment income which are received gross are taxed on a PY basis (eg income from furnished lettings, income from overseas). The transition from a PY basis to the new system for these types of income would be similar to the transition for income from self-employment (see Chapter 5 above). The final PY year would be taxed on the income of the preceding year and the first CY year on the income of the current year. The income for the intervening period would be left untaxed. The effect would be to bring forward to the transition the drop out which would occur under the present rules on a subsequent cessation.

8.11 Higher rate tax on investment income which is received net is paid on a CY basis. The change to the new system could therefore be made without any income needing to be left untaxed or taxed twice. If all income which is taxed by assessment were brought into the new system, higher rate tax on investment income received net would become due earlier than at present (see Paragraph 8.8 above). It might therefore be appropriate to allow some phasing of payments over a transitional period if this happened, so that taxpayers would not have to pay two years' higher rate tax on investment income received net of tax in one tax year.

The borderline with PAYE

8.12 Even if all income which is taxed by assessment were brought into the new system, employees and pensioners could continue to be taxed by deduction at source and through the PAYE

system as far as possible. They would only come into the new system then if they had investment income which could not be taxed fully in this way. Employees and pensioners who may have to pay tax by assessment are normally sent a return to complete each year. Provided the return was made sufficiently early (see paragraph 3.21 above), the Revenue would be able to tell the taxpayer whether the investment income would be taxed wholly through the PAYE system and by deduction at source or whether tax would need to be paid under the new system. The balance for the year and the first interim payment for the next year would then be due on 1 January. If the liability was not likely to continue, for instance because the income had ceased, the taxpayer would be able to reduce the interim payments to nil.

Summary

8.13 Views are sought on whether, if the new system is introduced for taxing the self-employed, all income which is taxed by assessment should be brought into the new system at the same time so as to give a more unified system all round for personal taxpayers (paragraphs 8.4 to 8.7).

CHAPTER 9: MISCELLANEOUS PROPOSALS

9.1 This chapter looks briefly at some of the consequential changes which would be needed, further simplifications which would be possible and areas where further changes might need to be considered if the new system were introduced.

Trading losses

9.2 The rules for giving loss relief under the present system can be very complicated, for instance where losses arise in the opening years of a business. The introduction of the new system would help to reduce these complexities.

9.3 A self-employed taxpayer would be able to get an immediate reduction in tax payments under the new system where profits fell, by reducing the interim payments accordingly. This only happens under the present system where the taxpayer makes a loss.

9.4 As now, self-employed taxpayers would be able to set trading losses against other profits* for the same tax year (or accounting period) and the following tax year (or accounting period). Trading losses which could not be relieved in this way could be carried forward and set against profits from the trade in later years (or accounting periods). Relief would also be allowed against income of the preceding three years for losses made when a trade started or ceased.

Capital allowances

9.5 The introduction of the new system would make it possible to simplify the rules on capital allowances for the self-employed. First, there would be no need for special rules

* Footnote Including capital gains, following proposals in the 1991 Budget (Hansard, 19 March 1991, Col 171).

on basis periods for capital allowances. Capital allowances would be based on the same period of accounts as the earnings. Second, consideration could be given to whether it might be simpler if capital allowances were given as a deduction in arriving at the taxable profits rather than as a separate relief.

Partnership annuities

9.6 The introduction of the new system would make it possible to consider whether it might be simpler for all concerned if partnership annuities were normally paid gross, rather than net of tax, and allowed as a trading expense.

Other business income

9.7 The introduction of the new system would bring the rules for different types of income closer into line. This would make it possible to consider extending more widely the rules allowing other types of business income (such as rents and interest received by the business) to be included in the profits from the business rather than being treated separately in the tax computations. This would help to further simplify the computations.

Personal allowances and reliefs

9.8 It would help to simplify the new system further if the rules for personal allowances and reliefs were framed so that these could in general be claimed in the tax return, for instance by ensuring that they depend only on information which would normally be available to the taxpayer when the return was completed. This would help to ensure that self-employed taxpayers would not normally need to amend returns or payments. But where exceptionally taxpayers did need to make further claims, the time limit for amending the return by the taxpayer

would be the same as the time limit for making further assessments by the Revenue (see paragraph 6.10 above).

National Insurance Contributions

9.9 There would be no need for changes to the present rules for computing the Class 4 National Insurance contributions (NIC) which the self-employed pay or for giving relief for half the contributions paid against the earnings from self-employment. The contributions would continue to be paid with the tax from the self-employment. Both the interim payments and the final payment under the new system would be based on the total liability to tax and Class 4 NIC.

Capital Gains

9.10 There would be no need for changes to the present rules for charging tax on capital gains if the CY basis were introduced. Some amendments would be needed for the AP basis. Capital gains tax could possibly be brought into a more unified system under either basis in the longer term, for instance by including the capital gains tax in the final balancing payment which is due with the return, although not in the interim payments.

Subcontractors in the construction industry

9.11 There are special arrangements for the payment of tax by subcontractors in the construction industry. Subcontractors who do not have an exemption certificate receive payments under deduction of tax. The tax deducted during the tax year is credited against the tax due for the year. If the tax deducted exceeds the tax due, the subcontractor gets a repayment. If the tax deducted is less than the tax due, the subcontractor pays the balance outstanding.

9.12 The new system would not require changes to be made to these arrangements. Tax deducted from payments during the tax year could continue to be credited against the tax due for the

tax year. The interim payments and the final payment would be based on the net liability, if any, after giving credit for the tax deducted from payments.

Lloyd's underwriters

9.13 Lloyd's underwriters are another group of taxpayers with special arrangements for the payment of tax. These arrangements are broadly compatible with the proposals for the new system. But further consideration would need to be given to the detailed arrangements for aligning the taxation of Lloyd's underwriters with the new system.

Other groups

9.14 There are special rules for various other types of businesses, eg farmers and authors. These rules are broadly compatible with the proposals for the new system. Here too further consideration would need to be given to the detailed arrangements for dovetailing the treatment of these groups with the new system.

Summary

9.15 Views are sought on the proposals discussed in this chapter. Other proposals for simplifying the system for taxing the self-employed would also be welcomed.

ANNEX 1: HOW THE SELF-EMPLOYED PAY TAX IN OTHER COUNTRIES

1. This annex looks at the arrangements for paying tax by the self-employed in other OECD countries.
2. Difficult problems arise in making any sort of international comparison. Comparisons can rarely be of like with like, or show the whole picture. So the comparisons made in this annex and any conclusions drawn from it could be misleading unless its limitations are appreciated.
3. The information provided may be subject to change, although it is as up to date as possible.

General comparisons

4. Wages and salaries are taxed at source in nearly all OECD countries. Most OECD countries also tax some types of investment income at source. Other types of income, including income from self-employment, are taxed by assessment.
5. Most OECD countries have a unified system of personal taxation under which the majority of taxpayers complete an annual tax return and pay tax, or receive a repayment, on the whole of their income after giving credit for interim payments of tax and for tax paid at source.
6. In most OECD countries, the self-employed and other individuals paying tax by assessment make interim payments on fixed dates during and following the tax year. Some countries base the interim payments on the liability of the previous tax year, others on an estimate of the liability for the current year. There is then a final balancing payment or repayment with the return or when an assessment is made.
7. Canada, Italy, Japan, Spain and the USA have full self-assessment systems under which the taxpayer calculates the tax due and pays it to the tax authorities. Australia and

Ireland are currently introducing self-assessment systems. Other OECD countries have a mixture of assessment by the taxpayer and by the Revenue.

8. Accounts and tax computations have to be supplied with the return in other OECD countries. They also all have sanctions against late or inadequate payments and against late returns.

9. OECD countries generally allow self-employed taxpayers to make up accounts to any date that they choose and use the CY basis. Some countries have rules to ensure that accounts are normally for a period of 12 months. A few countries also have special rules for working out the tax at the commencement or the cessation of a business.

Details for some OECD countries

Australia

10. Australia is in the process of moving from a system similar to the present one in the UK to one broadly similar to the proposals for the CY basis in this paper.

11. In 1986/87 Australia made its first move towards self-assessment. Under this first stage, taxpayers continued to make returns containing detailed information and their calculation of the amount of taxable income, but the returns were no longer subject to the technical and other scrutiny by the Revenue which had previously been undertaken prior to assessment. Emphasis shifted to subsequent audit in selected cases and to the provision of advisory services for taxpayers.

12. The Australian Government published a consultative document on 13 December 1990 on a full self-assessment system. The key proposals include the elimination of the receipt, checking and handling of bulky paper returns and the introduction of automatic interest and penalties for late payments and late returns. The Australian Government predicted that these changes

would significantly reduce compliance costs for taxpayers and administrative costs for the Revenue.

Canada

13. Canada has a full self-assessment system. Income from self-employment is taxed on the CY basis. Interim payments are made in four instalments during the tax year based on the liability for the previous year. Late payments attract automatic interest and surcharges. The final balance is due with the return four months after the end of the tax year. There is an automatic penalty of five per cent of the tax due plus one per cent per month for late returns.

Denmark

14. Income from self-employment is taxed on the CY basis, with special rules for cessations. Interim payments are made in ten instalments based on the liability for the previous year increased in line with inflation. Late payments attract automatic interest and surcharges. The return is due four months after the end of the tax year, with automatic penalties for late returns of two per cent of the tax due for delays of less than nine days and five per cent for longer delays, subject to a maximum of Dkr2000 (approximately £200). The final balance is due in three instalments during the following tax year.

France

15. Income from self-employment is taxed on the CY basis. Interim payments are made during the following tax year based on the previous year's liability. Late payments attract automatic interest and surcharges. The return is due two months after the end of the tax year with automatic penalties of 10 per cent of tax due for late filing, increasing to 40 or 80 per cent for longer delays. The final balance is due after assessment by the Revenue in the following tax year.

Germany

16. Income from self-employment is taxed on the CY basis. Interim payments are made in four equal instalments during the tax year based on the previous year's liability. Late payments attract automatic interest and surcharges. The return is due five months after the end of the tax year with penalties for late filing of up to 10 per cent of the total tax due. The final balance is due after assessment by the Revenue in the following tax year.

Republic of Ireland

17. Ireland is in the process of moving from a system virtually identical to the present one in the United Kingdom to one broadly similar to the proposals for the CY basis in this paper. The emphasis of the reforms has been to reduce the compliance burdens on taxpayers and the administrative costs for the Revenue and to provide a better service for taxpayers.

18. Income from self-employment will be taxed on the CY basis, except for the opening and closing years which will be on an actual basis (ie complex deeming, see Annex 2, paragraph 7). The transition from the PY basis to the CY basis is being made in the same way as proposed in this paper. Self-employed taxpayers will make an interim payment by 1 November in the tax year equal to the liability for the previous year. The final balance will be due together with the return by 31 January in the following tax year. Late payments will attract automatic interest and surcharges. There will be an automatic penalty of 10 per cent of the tax due for late returns.

Italy

19. Income from self-employment is taxed on the CY basis. Interim payments are made in two instalments based on 95 per cent of the previous year's liability. Late payments attract automatic interest and surcharges. The final balance is due

with the return five months after the end of the tax year. Penalties for late or incorrect returns can be between 50 per cent and 100 per cent of tax due for delays up to one month and between 2 and 4 times the tax due or imprisonment for longer delays.

USA

20. The USA has a full self-assessment system. Returns and accounts are normally made for the tax year although some self-employed taxpayers are allowed to use the AP basis. Interim payments are made in four instalments during the tax year based on the liability for the previous year. The final balance is due together with the return three and a half months after the end of the tax year. Late payments attract automatic interest and surcharges. There is an automatic penalty of five per cent of the tax due plus five per cent per month for late returns.

ANNEX 2: OTHER PROPOSALS CONSIDERED BY THE REVIEW

1. This annex looks at some of the other proposals which were considered by the review of possible systems.

2. There is a wide range of possible options for the components of a new system and ways in which these could be put together. This annex does not attempt to describe all the options and combinations which would be possible or to explain in detail why particular options and combinations were considered less attractive. But it does try to set out the main options which were considered and the main arguments for and against them.

Fixed filing dates and payment dates

3. The review concentrated on systems with fixed filing dates and fixed payment dates backed up by effective sanctions for late filing and late payments. These are standard features of the systems for taxing the self-employed in other countries. They would appear to provide the only workable alternative to the present rigmarole of estimated assessments, postponement applications, delay hearings and amendments to assessments.

Current year basis

4. A current year basis is also a standard feature of systems in other countries. It would appear to be needed in order to do away with complicated rules for commencements and cessations, the mismatch between the profits assessed over the life of a business and the profits earned and to open up the way for further reforms to simplify, unify and improve the system of personal taxation.

Alternative current year basis

5. A number of alternative current year bases have been proposed in the past.

6. Under the fiscal year basis, all self-employed taxpayers would be required to make up their accounts to 5 April (or 31 March). This basis is used for most taxpayers in the USA. It is in many ways the ideal technical solution. It is readily understood and would be very easy for the taxpayer to get right. It results in a high degree of equity between taxpayers. It produces no problems with, nor does it require special rules for, commencements and cessations. It lends itself readily to reduced Revenue involvement and to greater unification of the personal tax system. The main disadvantages of the fiscal year basis however are that the imposition of an accounting date purely for the purposes of tax administration might be regarded as objectionable in principle. It would also tend to compress the work of accountants into the same period of the year and coincide with work on returns.

7. The complex deeming basis is similar to the CY basis except that the opening and closing years are assessed on an actual basis (eg first year on actual, second year on actual or first 12 months whichever is less, penultimate year on actual or accounts whichever is greater, final year on actual). This basis is used for the new system being introduced in Ireland. It avoids the tax holiday at commencement and the increased liability at cessation which can occur under the CY basis if the taxpayer chooses an accounting date early in the tax year. It has the disadvantages that it perpetuates the problems from the present system of the mismatch between profits assessed and profits earned and the need for special rules for commencements and cessations. It would offer only limited simplification or assistance towards reduced Revenue involvement and greater unification of the personal tax system.

8. Under the apportionment basis, the income for accounting periods straddling the fiscal year would be apportioned to arrive at the taxable income for the tax year. It is not used in any other country, as far as is known. The apportionment basis is technically correct, avoids any problem of mismatch between the profits assessed and the profits earned, and

achieves a high degree of equity between taxpayers whilst allowing businesses to make up their accounts to any date that they choose. It has the disadvantages however that it would provide no assistance towards simplification and streamlining of the system for taxing the self-employed, nor towards reduced Revenue involvement and greater unification of the personal tax system.

9. Most other countries use the CY basis, although some have rules to ensure that tax is normally paid on profits earned in a period of 12 months. Some countries use the fiscal year basis and the USA uses the fiscal year basis for most taxpayers with the AP basis for some.

Transition to the new system

10. An alternative way of handling the transition would be to have a deemed cessation under the present rules and a deemed commencement under the new rules at the date of transition. This would require special rules to ensure that interim payments began straight after the transition so that the flow of tax payments would continue broadly unchanged. It would mean that complicated computations had to be made in every case for up to 3 years before the transition and perhaps 2 years after the transition. This would increase compliance burdens on taxpayers and administrative costs for the Revenue. The cessation provisions under the present rules would also result in additional liabilities at the transition for many taxpayers.

Corporation Tax

11. Under the present system, the self-employed pay tax partly in the tax year. Companies on the other hand pay corporation tax wholly after the end of the period being assessed. Consideration was given to whether the self-employed should move to a similar system, for instance by moving the payment dates for the self-employed one year later.

12. The comparison with the payment of corporation tax is somewhat misleading as the proprietors' share in the profits of small proprietorial companies are mostly distributed in the form of directors' remuneration and dividends on which tax is paid in the tax year. Corporation tax, by comparison, generally makes up a very small part of the tax paid on proprietors' profits in small companies.

13. Deferring payment dates for the self-employed would reduce equity with employees. It would also leave a large gap in Exchequer receipts. This could be made up by requiring the self-employed to pay an additional year's liability at the transition by taxing the profits which would otherwise go untaxed. This would require complicated provisions to deal with changes in partnerships, changes of business, etc. And it would mean that self-employed taxpayers would pay tax over the life of a business for one more year than the business was in existence.

14. Deferring payment dates for the self-employed would also be a step in the wrong direction for further simplification of the personal tax system. By moving the payment dates for employees and the self-employed apart, it would make it more difficult or even impossible to introduce a more unified and coherent system for personal taxpayers.

Interim payments in estimated figures

15. In most other countries, payments are made using figures which have already been returned by the taxpayer. In particular, interim payments are made using figures which have already been returned by the taxpayer for a previous year.

16. Under the new system which is being introduced in Ireland, interim payments may be made in figures estimated by the taxpayer. The interim payment is based on the liability for the previous year but has to be made before the filing date for the return for that year. The Irish Revenue however recommend tax practitioners to file returns before the due date for the interim

payment, so that the interim payment can be made using returned figures. They suggest that as practitioners would need all the information required to complete the tax return in order to make the estimated payment, the most efficient approach would be to complete the return and file it early.

17. Under Pay and File, companies will make an initial payment of corporation tax using a figure estimated by the company. This was thought necessary for Pay and File for a number of reasons. First, in order to allow 12 months for accounts to be prepared the interim payment is due three months before the return. Second, corporation tax liabilities frequently change as a result of subsequent events, for instance group relief claims and carry back of losses or surplus ACT. Third, both for this reason and the general variability of corporation tax liabilities, the liability for the previous accounting period does not provide a reliable basis for an interim payment of corporation tax.

18. Consideration was given to whether interim payments should be made using estimated figures or returned figures under the new system. It was concluded that there was not the same need for payments in estimated figures as under Pay and File and that payments in returned figures would make the system both simpler and more efficient.

Filing returns and accounts

19. It is a standard feature of systems in other countries that accounts and tax computations are filed with the return. Consideration was given to whether separate filing periods could be allowed for returns and for accounts under the new system. It was concluded that a single filing period would make the new system both simpler and more efficient. Separate filing periods would be more complicated, both for taxpayers and the Revenue. They would also require separate sanctions for late filing, which would be likely to result in larger penalties overall for

defaulters than would arise with a single filing period. And they would not be consistent with the introduction of a more unified system for personal taxpayers.

20. Consideration was also given to whether more than nine months from the end of the tax year could be allowed for filing the return and accounts under the CY basis. But this would mean that the first interim payment for the current year was due before the return for the previous year. If all payments are to be made in returned figures, the first interim payment would have to be based on the final liability for two years previously. This would make the system very complicated, both for taxpayers and the Revenue. And for the reasons explained above, the alternative of allowing interim payments to be made using estimates by the taxpayer of the liability for the previous year or for the current year were considered to make the system too complicated.

21. For the same reasons, the return and accounts would be required nine months after the end of the accounting period under the AP basis if payments were to be made in two main instalments, or twelve months after the end of the accounting period if payment were to be made in one main instalment.

ANNEX 3: A CASE STUDY

1. Jim Smith is a grocer. He makes up accounts for the business to 31 August. His accounts for the year ended 31/8/95 show taxable profits of £20,000, and for the year ended 31/8/96 £21,000. Jim also owns another shop which he rents out at £400 a month, increased to £450 a month from 1/4/96.

2. Jim has a mortgage which is not within MIRAS. He pays gross interest of £2,400 in 1995/96 and £3,000 in 1996/97. His personal allowances are £4,000 for 1995/96 and £4,200 for 1996/97. This study assumes that income tax is paid at 25 per cent for both tax years and ignores Class 4 NIC.

The present system

3. Under the present system, Jim's dealings with the tax office for the 1996/97 tax year might go something like this.

1/9/96	Inspector makes an assessment for 1996/97, grocer £25,000 (estimated), rents £4,800, tax due £6,400.
15/9/96	Jim appeals and applies to postpone £2,500 leaving first instalment £2,050 and second instalment £1,850.
1/10/96	Inspector agrees the postponement application.
1/1/97	Jim pays £2,050 to the Revenue.
1/7/97	Jim pays £1,850 to the Revenue.

- 1/8/97 Inspector writes to Jim asking for his return and accounts.
- 1/9/97 Inspector writes again giving Jim a final warning that his return and accounts are overdue.
- 1/10/97 Jim receives a summons to appear before the General Commissioners on 1/11/97.
- 1/11/97 General Commissioners adjourn the hearing of Jim's appeal for one month to allow the return and accounts to be produced.
- 30/11/97 Jim sends his return for 1996/97 to the Inspector together with his accounts for the year ended 31/8/95. The return shows his income in 1995/96 and his reliefs and allowances for 1996/97.
- 1/3/98 Following further correspondence, the Inspector agrees Jim's figures and sends him an amended assessment for 1996/97 showing:

Grocer	£20,000
Rents	£ 4,800
less Mortgage interest	(£ 3,000)
Personal allowances	<u>(£ 4,200)</u>
Net taxable income	£17,600
Tax due @ 25%	£ 4,400

Jim also gets a demand for the balance of the tax due, £500, plus interest.

- 1/6/98 Jim sends in his return for 1997/98, which includes details of the rents in 1996/97.

1/8/98

The Inspector sends Jim a further assessment for 1996/97 showing:

Rents	£ 5,400
less already assessed	<u>£ 4,800</u>
	£ 600
Tax due	£ 150

The CY basis

4. Under the CY basis, with a unified basis for all assessed taxes, Jim's dealings with the tax office for 1996/97 would go something like this.

1/1/97

Jim sends his return for 1995/96 to the Inspector, together with his accounts for the year ended 31/8/95. The return shows his income reliefs and tax for 1995/96. Jim's computation of his tax liability in the return shows:

Grocer	£20,000
Rents	£ 4,800
less Mortgage interest	(£ 2,400)
Personal allowances	<u>(£ 4,000)</u>
Net taxable income	£18,400
Final liability @ 25%	£ 4,600

Jim pays first interim payment for 1996/97 of £2,300 (ie half the final liability for 1995/96).

1/7/97

Jim pays his second interim payment for 1996/97 of £2,300.

1/1/98

Jim sends his return for 1996/97 to the Inspector together with his accounts for the year ended 31/8/96. The return shows his income, reliefs

and tax for 1996/97. Jim's computation of his tax liability in the return shows:

Grocer	£21,000
Rents	£ 5,400
less Mortgage Interest	(£ 3,000)
Personal allowance	<u>(£ 4,200)</u>
Net taxable income	£19,200
Final liability @ 25%	£ 4,800
less already paid	<u>£ 4,600</u>
Final balance due	£ 200

Jim pays the balance due for 1996/97 of £200.

The AP system

5. Under the AP system with payment in two main instalments, Jim's dealings with the tax office for the accounting period ended 31/8/96 would go something like this.

1/6/96 Jim sends his return and accounts for the year ended 31/8/95 to the tax office. His computation of the tax due for the year is £4,400 say.

Jim pays his first interim payment for the accounting period ending (APE) 31/8/96 of £2,200 (ie half the final liability for APE 31/8/95).

1/12/96 Jim pays his second interim payment for APE 31/8/96 of £2,200.

1/6/97 Jim sends his return and accounts for the APE 31/8/96 to the Inspector. His computation of the tax due looks like this:

1/9/95 to 5/4/96

Grocer	$\pounds 21,000 \times 7/12\text{ths} =$	$\pounds 12,250$
Rents		$\pounds 2,800$
Less interest	$\pounds 2,400 \times 7/12\text{ths} =$	$(\pounds 1,400)$
Personal allowances	$\pounds 4,000 \times 7/12\text{ths} =$	<u>$(\pounds 2,333)$</u>
Net taxable income		$\pounds 11,317$
Tax due @ 25%		$\pounds 2,829$

6/4/96 to 31/8/96

Grocer	$\pounds 21,000 \times 5/12\text{ths} =$	$\pounds 8,750$
Rents		$\pounds 2,250$
Less interest	$\pounds 3,000 \times 5/12\text{ths} =$	$(\pounds 1,250)$
Personal allowances	$\pounds 4,200 \times 5/12\text{ths} =$	<u>$(\pounds 1,750)$</u>
Net taxable income		$\pounds 8,000$
Tax due @ 25%		$\pounds 2,000$
Total tax - final liability		$\pounds 4,829$
Less already paid		<u>$\pounds 4,400$</u>
Final balance due		$\pounds 429$

Jim pays the balance of the tax due of $\pounds 429$.